If Able were a big bully and could simply steal half of his neighbors' catch every day, then it would be true that his relative wealth would be derived from the relative poverty of those he oppresses. But these actions, which would involve forcing others to do something against their own interests, would not increase the island's overall productive capacity. He would simply take what others have produced, and the island's production would remain the same. More likely, overall capacity would fall. The oppressed would cut back on their work when they realized the fruits of their labor would be stolen.

Large-scale examples of such coercion dominate history. Slavery, serfdom, and peasantry all come to mind. And while workers do respond to force when their self-interest is denied, they respond far better if they are the beneficiaries of their labor.

Unfortunately, examples of large-scale economic freedom are rare in global history. But when self-interest is allowed to flourish, productive capacity expands quickly.

The use of credit is the perfect example of how economic freedom works to everyone's benefit. As long as lenders and borrowers are free to strike their own terms, the collective results will be a success. However, as we will see later on, the market for loans can be distorted by outside forces. When it is, disaster usually ensues.

CHAPTER 3

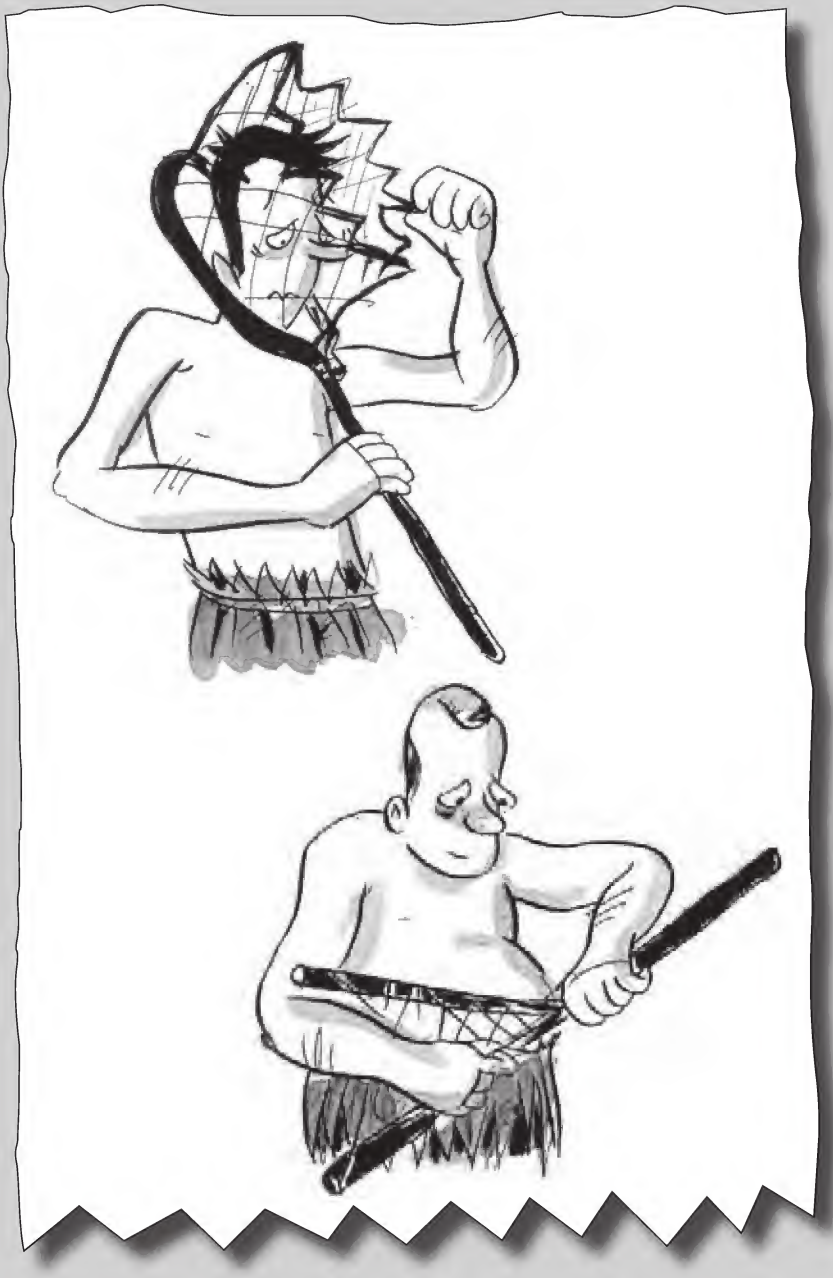
THE MANY USES OF CREDIT



As we have just seen, Able decided to loan Baker and Charlie fish so that they could build nets. Business loans such as these are the best use of saved capital because they tend to expand production.

Of course, the act of lending money—or fish—to start a business is no guarantee that the venture will be successful. A borrower may not be able to fully execute on his initial plan.

That's what would have happened if Charlie and Baker failed to produce successful nets.





In other instances, a business may fail because the idea never held any promise to begin with. Suppose instead of asking for a loan to build a net, Baker and Charlie asked Able for a loan that would allow them to perfect a technique for mass fish hypnosis.

If the fish wouldn't fall for it, the loan would produce no benefit for the borrowers—Charlie and Baker—or the lender—Able.

The bottom line is that loans made to businesses that do not succeed waste society's store of savings and diminish productive capacity. As a result, the lender may then have trouble getting back his principal, let alone the interest.

But the business plans that work make up for the ones that don't!

It is important to understand that business loans are not the only option for society's store of savings. There are other types of loans that Able could have made—consumption loans and emergency loans.

Consumption Loans

Suppose that rather than making a loan to Baker and Charlie to build their own nets, Able had succumbed to their demands for a loan so they could take a vacation.

✔ REALITY CHECK

Whenever an outside force, such as government, encourages or demands that savers make loans for reasons that may have nothing to do with the actual likelihood of repayment, higher degrees of loss are almost inevitable. Such distortions waste society's savings.

In their zeal to do something good, governments like to influence the way savings are lent out. They pass laws that make some types of loans more appealing than others. But government has no savings; only individuals do! If, as a result of government incentives, the loans go to individuals or businesses that fail to pay off (and they often do), then the loss falls to those individuals who have sacrificially under consumed to create savings!

In fact, Able would be much less inclined to lend in the first place if he were forced to make loans that he felt were excessively risky, such as in the case of fish hypnosis. As a result, he may decide not to work as hard, or not to sacrifice as much to save!

"Hey, Rocke-fisher," griped Baker. "Maybe you should take a break from fish counting and lend me and my pal Charlie a couple of fish so we can kick back a day or two. You're not the only one who deserves a life of leisure. And besides, we'll pay you back."

"Believe me, I know that fishing can get to be a drag," responded Able. "But remember, if I lend you one fish, I'll still want two fish in return to compensate me for the risk."

"No sweat, Kingfish," countered Charlie. "We'll be so well rested after our vacation, we'll be able to fish even harder and pay you back, with interest."





But how will Baker and Charlie be able to repay the vacation loan, with interest, if they do not expand their productive capacity? After taking a few days off, they will still only be able to catch one fish per day. To repay Able, they will need to cut their consumption to less than one fish per day in the future. Their living standards would have to drop to repay the loan!

Knowing this possible consequence, Able tried to be reasonable. "Look guys, why borrow now and go hungry to repay the loan, when you can just sacrifice now, go hungry for one day, build your own net, save up for the future, and then rest up whenever you want?"



"Listen," said Baker and Charlie. "Save the holier-than-thou bunk. Just give us the fish!"

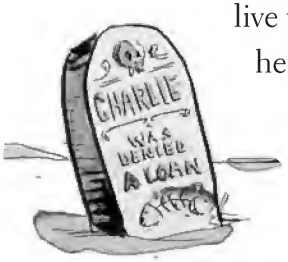
Able should deny the loan. Not only would such a transaction put his savings at unnecessary risk, but it would mean that the capital would be unavailable for more productive loans. And while he will earn their scorn, he will actually prevent future hardship. In actuality, loans to consumers that do not fundamentally improve productive capacity are a burden to both the lenders and the borrowers.

Emergency Loans



As it turns out, Able's rejection of Baker and Charlie's "vacation" (consumption) loans was extremely fortunate. A week later, both are struck by a freak outbreak of the Pokalani Pox, which prevents them from fishing for a week.

Now, when this emergency arises, Able is in a position to make a hardship consumer loan out of his accumulated savings so that Baker and Charlie can eat and live to work another day. Although he also understands that the risk of nonrepayment is high, he understands that the risk in not making the loan is higher. Unlike the consumption loan, Baker and Charlie can perish if the emergency loan is not made. If this were to happen, the island would lose productive capacity.





This emergency loan would not have been possible if Able had already given away his savings through unproductive consumer loans.

In fact, savings can mean the difference between the life and death of society.

✔ REALITY CHECK: CAN ABLE EXPAND CREDIT?

When confronted with the possibility of economic contraction, politicians and bankers frequently discuss the need to "expand credit" by increasing the amount of money available to be lent. But can this be done on command? In the case of our fishing friends, how can Able legitimately lend out more fish than he has saved? The island's total supply of credit is limited by its total supply of saved fish.





TAKEAWAY

Unfortunately, it is widely accepted that in order to spur activities that politicians and social theorists deem to be beneficial, government influences how savings are allocated. This has been accomplished by a litany of government loan guarantees and corporate and individual tax credits and penalties.

As a result of these influences, individuals and businesses may be more willing to apply for, and banks may be more willing to grant, certain types of loans. More of society's resources are then directed toward the favored activity, whether it be home building, college attendance, or solar panel manufacturing.

Central to these impulses is the notion that government planners have a better idea of what's good for society than savers themselves. But there is no evidence that this is true. In fact, history is littered with grandiose schemes hatched in government think tanks that have simply not delivered on their promise.

But more fundamentally, the imposition of a government layer in between savers and borrowers separates the cause and effect of lending, and leads to an inefficient allocation of savings.

Private lenders tend to be influenced only by the financial results of a loan, rather than the political symbolism of the underlying activity. Businesses that adhere to successful models and are run by owners with strong records of

achievement tend to repay loans at higher rates. As a result, these types of business plans tend to attract willing lenders. Much like Darwin's idea that natural selection produces hardier species, this lending discipline tends to produce healthier companies and a stronger economy.

But this does not occur when financial performance becomes secondary. Loans made to individuals or enterprises that do not succeed in creating a needed innovation or expanding productive capacity tend to weaken the overall economy by wasting the supply of savings.

But as we will see later in the book, the creation of a constantly expanding money supply, and the government's seemingly limitless ability to take on debt, have hidden the fact that real credit is limited by a finite supply of savings.

People now assume that all that is needed for a functioning credit market is willing borrowers. But like any other resource, savings must be accumulated before it can be lent out.

CHAPTER

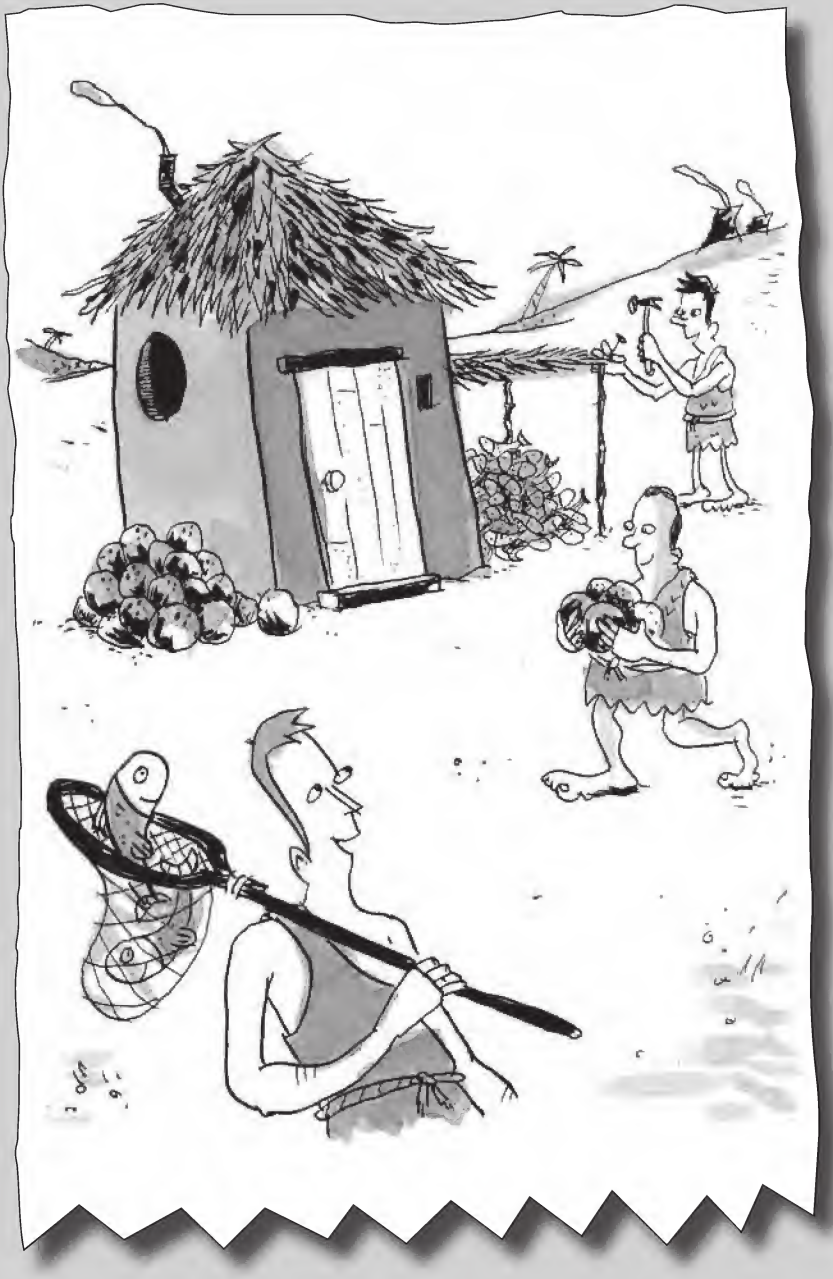
4

ECONOMIC EXPANSION



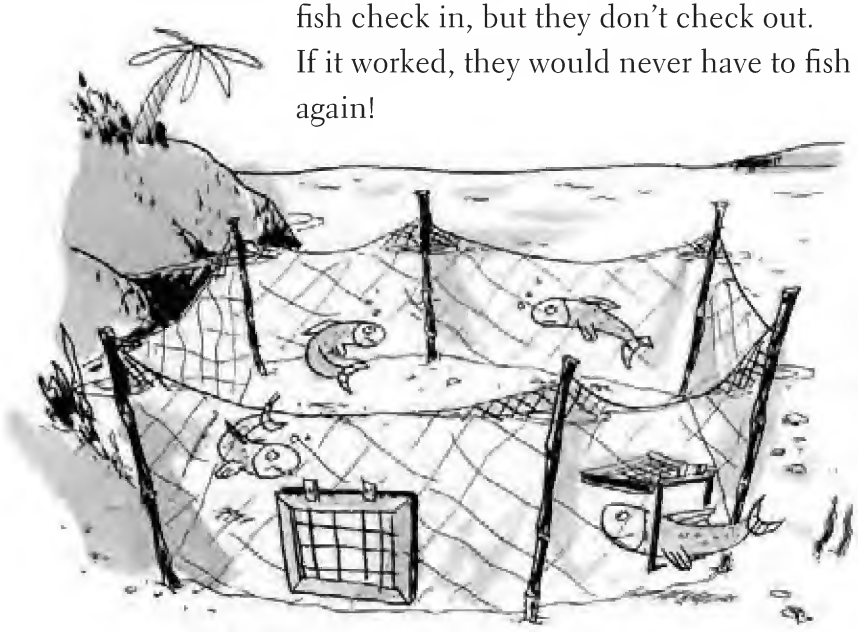
After a few weeks, Able, Baker, and Charlie had been raking in the fish with their newly built nets, and a two-fish-per-day catch had become the norm. After a threadbare one-fish- per-day diet, who could blame them? But having experienced the benefits that flow from self-sacrifice, they decided to save a good portion of that potential consumption. Every couple of days, they made do with just one fish apiece.

Released from the need to fish every waking moment, the islanders finally had the freedom to undertake other productive and enjoyable activities. Able was able to devote some time to designing and constructing more functional—and more flattering—palm-leaf clothing. Baker expanded his diet and culinary skills by gathering coconuts, and Charlie built the island's first hut.



Things were going well, but Baker was convinced they could be even better. He said, "If we can expand production with hand nets, why not kick it up a notch and go industrial?" He envisioned a larger and better piece of capital equipment.

He sketched out the plans for an elaborate fish-catching device that would revolutionize the island's economy. The gizmo involved a huge underwater trap with one-way doors that could catch fish continually day or night. That's right—fish check in, but they don't check out. If it worked, they would never have to fish again!



But, Baker soon realized that the he was unable to handle such a complex project by himself. He thought about the materials necessary, the netting, the framework, the construction. His savings, brawn, and ingenuity were simply not enough for such a colossal project.

With these thoughts in mind, Baker decided to propose a joint venture. The three could form a company, under-

consume for a while, pool their savings, and dedicate an entire week to construction.

Having listened to Baker's plan, they began to discuss the potential risks. As with Able's first net, there was no guarantee that the project would work. Even if it did, the whole contraption could fall apart in its first exposure to rough seas. But this time it wasn't just one fish they were risking, but more than 20!

However, their demand for more fish overpowered their fear of losing their savings.

They moved forward.

After a supreme effort, the three succeeded in building the island's first mega fish catcher. The trap delivered as advertised and racked up an average of 20 fish per week, with no fuss and barely any muss. Outside of some minor repairs and maintenance, the trap was almost entirely automated. Soon they were swimming in fish.

With the savings that quickly piled up due to this latest advancement in productivity, the three soon built another mega fish catcher.



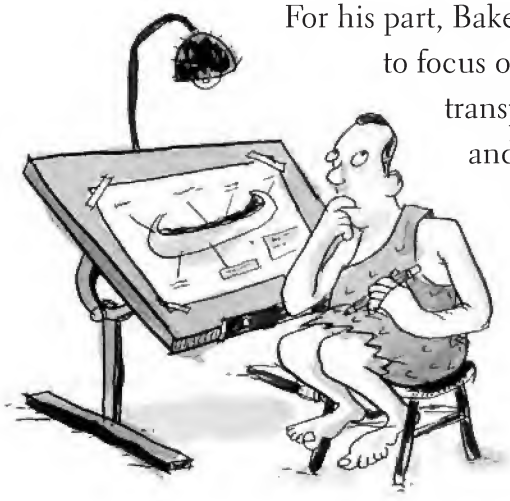
Fish became so abundant that they were able to dedicate all their time to other projects.



Charlie used his savings to build surfboards, resulting in a new ultracool leisure activity.

Able used his savings to establish a clothing company that would produce items not just for himself but for any islander who wanted to freshen up their image. In his spare time, he began working on his one-man stage play.





For his part, Baker used his free time to focus on the island's vexing transportation problems, and developed designs for the island's first canoe and cart.

✔ REALITY CHECK

Savings are not just a means to increase one's ability to spend. They are an essential buffer that shields economies from the unexpected.

Suppose a monsoon came through the island and wiped out both mega fish catchers? Although many economists today view natural disasters as stimulative to an economy, the truth is floods, fires, hurricanes, and earthquakes destroy wealth and diminish living standards. If the fish catchers were wiped out, the island's fish production would drop, and Able, Baker, and Charlie would have to underconsume again in order to generate savings to rebuild their capital.

But, remember, a pool of spare savings prevents disruption and allows for immediate reconstruction of damaged capital. That is why it is essential that Able, Baker, and Charlie continue to underconsume and save for a rainy day.



TAKEAWAY

In the past, the United States was known as a nation of savers. Throughout much of our history American citizens typically saved 10 percent or more of their incomes annually. This discipline not only helped build a huge supply of savings to finance our growing industrial activity, but it also helped families and communities endure unexpected hardships.

However, in recent years, economists have severely downgraded savings on the economic value chain. In fact, as far as many economists are concerned, savings are a drag. Keynesians view savings as detrimental to growth because the act removes money from circulation and decreases spending (which they assume is the crucial element in creating economic growth). Policy makers, influenced by these ideas, have made rules that reward spenders and penalize savers.

As a result, Americans have, for years, spent more than we have earned. In a contained economy, like an island, this would be impossible. But in our modern world, the flow of money across borders and the seemingly magical qualities of the printing press have temporarily blinded many Americans to the simple truth that we can't consume more than we produce, or borrow more than we save…at least not for very long.

When the economic headwinds began to pick up in earnest in 2008, politicians and economists reflexively looked for a means to get consumers to spend even more and save even less.

They have it backward. Spending for its own sake means nothing. What if you spent $1 million, but bought nothing but air? How would this benefit society? It would surely benefit the person who sold you the air. He would get the million dollars formerly belonging to you. Using our modern methods of economic accounting, such as the measurement of gross domestic product (GDP), such a transaction would certainly look like genuine activity. It would be counted as $1 million worth of growth.

But the act of buying air does not improve the economy as a whole. The air was always there. Something has to be produced to give the spending any value.

Spending is merely the yardstick that we use to measure production. Since everything that is produced will eventually be consumed, why does spending really matter? Even the stuff that no one really wants will be consumed if the price falls far enough. But nothing can be consumed until it is produced. It's production that adds the value.

Saving creates the capital that allows for the expansion of production. As a result, a dollar saved makes more of a positive economic impact than a dollar spent. Just don't try to explain this to an economist or a politician.

CHAPTER

5

PROSPERITY LOVES COMPANY



The same economic rules that operate in a simple economic society also apply to a more complicated one.…

Able's initial willingness to create capital through his own personal sacrifice benefited the other islanders. As a result of his prudent lending program, the islanders built many hand nets, and then capitalized on the increased productivity to fund much more efficient fish-catching machines. In addition to allowing a better diet, more flattering attire, and easier transport, the increased productivity gave rise to leisure time and a burgeoning surfing scene.



Tales of this unprecedented luxury soon spread to other islands, where fishing was still done by hand and no one had time to surf. In search of a better life, immigrants soon arrived.



The greater productivity of the island meant that it could support a greater population, which in turn led to greater economic diversity. Some new immigrants went to work servicing the mega fish catchers, while others borrowed the extra fish to clear the land for farming—at last a balanced diet! Others took out loans to go into other trades.

The diversified island economy soon gave rise to hut builders, canoe builders, wagon builders, you name it.

Society had become so good at producing food and tools that some people didn't need to produce anything physical to survive. As a result, a service sector was born.

Looking to improve on the delectability of the raw fish, some islanders developed specialized systems of fish preparation, often involving spices and fire. The skills of these chefs became so highly prized that the more prosperous fishermen and hut builders would pay them fish in exchange for their delectable food and culinary skills.





Other service jobs developed soon after.

The allure and social benefits of surfing became so widely prized that Charlie's descendants founded a surfing school.

As the society grew and more trades and services were offered, a medium of exchange was needed so that the hut builder, chef, or surfing instructor could be paid.

Up till now, the island had functioned on a barter system, where one person traded one good or service for another. But this process was cumbersome and inefficient. A spear maker may want a chef, but a chef may not want a spear. Even if their desires did converge, how many cooked meals would a spear be worth, anyway?

To replace this system of haphazard deal making, the island needed something that could be traded for anything and that was accepted by everybody. In other words, they needed money.

Since everyone on this island ate fish, it was decided that fish would serve as money.



In short order, all wages and prices were quoted in terms of fish. And since subsistence was still imagined at one fish per day, one fish had a value to which everyone could relate. The island's price structure therefore was related to the real (or intrinsic) value of fish.

Efficiency and Deflation

An economy in which workers can specialize in a specific trade or service is always better than one where everyone does the same thing. Specialization increases production, which in turn raises living standards.

Let's say that it took the average islander five days to make a canoe. If it is assumed that every islander could catch two fish per day (with a net), then each person would have to forgo 10 fish of income in order to build a canoe. However, suppose one islander named Duffy was a little better at cutting, hauling, and chopping wood and could make a canoe in just four days.



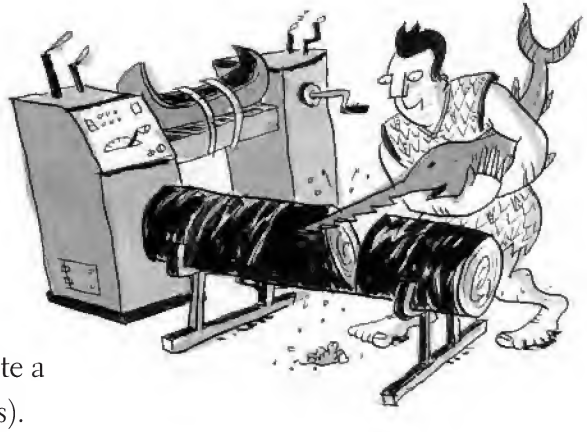
Rather than fishing like everybody else, Duffy would be much better off if he just made canoes. As he would only have to defer eight fish in income to build a canoe, he could make a profit by charging nine fish for one of his canoes. He could raise his income through specialization.

Given these advantages, other islanders would be wise to buy one of Duffy's canoes for nine fish. (Left to themselves, they would have to give up 10 fish in income.) By paying only nine to a specialist, they could save one fish.

But suppose nine fish represented a fairly steep price…after all, who has that many fish just lying around? Perhaps at those prices only the wealthiest islanders could afford a new canoe. Those who didn't have that level of accrued savings would just have to keep swimming until they had saved enough to pull the trigger.



But let's imagine that after years of cutting and shaping his logs with rocks and sharp shells, Duffy used **his** accumulated savings to build specialized canoe-making tools. Like Able many generations before, he was underconsuming in order to generate a capital good (tools).



Because of his better equipment, let's also imagine that Duffy cut his building time down to two days. With this increased efficiency, he would now only have to charge four fish instead of eight fish per canoe to break even. If he lowered his price to six fish (from nine) he would be more profitable on each canoe he sold (two fish per canoe instead of one), and he would be able to crank out twice as many units.

This increased productivity benefited not only Duffy, but all the islanders. More could afford a canoe priced at just six fish, so his customer base increased.



As a result of this improved efficiency—made possible by savings, innovation, and investment—the price for canoes came down and the benefits of canoe ownership became available to a wider pool of buyers. What was once a luxury for the rich became common for everyone.

✔ REALITY CHECK

As echoed in the preceding tale, falling prices don't hurt Duffy. In fact, as prices for all things come down through similar productivity gains in other industries, the fish he earns will enable him to buy more things.

Innovation is a one-way process. Unless people forget what they already know, efficiency always compounds. As a result, prices tend to come down over time.

Steadily dropping prices also encourage savings as islanders begin to understand that their fish would likely buy more goods in the future than they do today. As crazy as it sounds, a fish saved is indeed a fish earned. This encourages savings, thereby swelling the amount of capital available for loans.

Employment

As the society became more complex, more and more islanders decide to work for other people by trading their labor for wages.

The value of labor is always multiplied by the use of capital. The better the capital, the more valuable the labor. For instance, you can dig a bigger hole with a bulldozer than with a shovel, even if you work just as hard with both. Thus, it's best to work with the best capital available.

In a free society all the residents decide for themselves whose capital to use to magnify the value of their labor. Putting

aside those who metaphorically choose to fish without a net (perhaps for artistic reasons), each worker is free to:

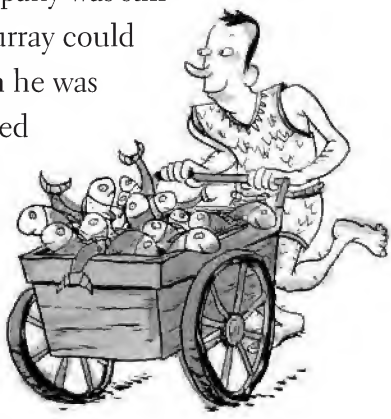
- Underconsume to build a net.
- Take out a business loan to buy a net.
- Work for someone who already has a net.

As the first option requires underconsumption, and the second option involves risk, most workers choose the third option. If they do, they are paid wages.



For instance, Finnigan, a new arrival on the island, was a very strong man. His talents were wasted as a fisherman, so he decides to specialize in fish transport. Relying solely on his brawn, Finnigan was able to deliver 100 fish per day from the beach to people's huts. At a 2 percent freight charge, Finnigan could earn two fish per day working for himself.

However, having previously taken out a business loan to build a fish cart, Murray's Cart Company was stiff competition. Using his own cart, Murray could deliver 300 fish per day, even though he was not nearly as strong as Finnigan. Based on his high level of productivity, he charged only a 1 percent rate, thereby earning three fish per day. So because of his capital he was able to charge a lower rate and still earn more than Finnigan.



Without his own capital, Finnigan was in a pickle.

Assuming that the burlier guy could deliver 400 fish a day with a cart, Murray sensed an opportunity. As Finnigan could generate four fish per day in income with the cart (using the 1 percent delivery rate), Murray offered him three fish per day as an employee. Murray could keep the fourth fish as profit.

If Finnigan took the job, he would increase his productivity, lower his delivery rate, and earn more than he could by himself.

With the one-fish-per-day profit, Murray could stop delivering the fish himself, and focus on building more carts and expanding his business by hiring more delivery people. Meanwhile, proliferation of carts will bring down freight costs for all islanders.

Hopefully, at some point down the road, Finnigan could save up his income and build his own cart to compete against his former boss. In order to prevent this from happening, Murray would have to pay Finnigan more than he could have gotten on his own, and enough to discourage him from leaving the company.

But Murray's potential for profit is the sole motivation for all of this. He doesn't intend to help out Finnigan, but he does so inadvertently. The result is a better-paid worker and lower costs for all.



TAKEAWAY

There is no greater propaganda victory in economics today than the complete vilification of *deflation* (and the relative acceptance of *inflation*). As far as economists and politicians are concerned, deflation, which is defined as the overall decline of prices over time, is the economic equivalent of the bubonic plague. At the slightest whiff of deflation, governments will typically enact policies to push prices back up.

But what's wrong with falling prices? Habituated as we have become to steadily rising prices, it would shock just about everyone to know that prices in the United States fell steadily for almost 150 years…from the late 1700s all the way to 1913! But during that time we experienced some of the fastest economic growth in the history of the planet. This was made possible for the precise reasons described in this chapter: increased efficiency. When combined with a stable supply of money (as existed in the United States until the establishment of the Federal Reserve), efficiency will push prices down.

The vastly increased productivity of the industrial revolution made it possible for working-class people to afford all kinds of goods, like upholstered furniture, tailored clothing, plumbing, and wheeled transportation, that were previously available only to the rich. Deflation meant that $100 saved in 1850 could buy many more goods and services in 1880. Why is this not a good thing? While modern grandparents habitually point out how much cheaper stuff was when they

were kids, their own grandparents likely told stories to them about how much more expensive things were in their youth.

Yet despite the obvious benefits of lower prices, we still fear deflation. We are told that if prices were to fall, people would stop buying, companies would stop spending, workers would lose their jobs, and we would all return to the economic dark ages.

But we all see time and time again how falling prices do not deter particular industries. In the early twentieth century, Henry Ford made a fortune, and his workers became the best paid in the industry, by steadily bringing down the price of cars. More recently the computer industry has made bundles of money despite the fact that its products constantly experience significant price deflation. Yet despite plunging prices the computer revolution continues unabated. As a result of this efficiency in design and manufacture, millions and millions of people each year spend less and less to experience the marvels of digitization.

Despite this, most people assume that deflation is okay if it's confined to just one industry. Why would that be?

Modern economists mistakenly assume that spending drives growth, and that when deflation is present, people tend to defer purchases (to allow prices to fall); and when they do spend, the diminished price makes less of an economic impact. This is absurd.

As we've said before, it's not the spending that means anything. It's the production that counts!

People do not need to be persuaded to spend. Given that human demand is essentially endless, if people don't want something there is likely a good reason. Either the product is no good or the consumer simply cannot afford to buy it. Either way, the act of deferring a purchase, or saving instead of spending, is made for rational reasons and tends to benefit the economy as a whole.

In fact, if consumers are not spending, the best way to spur demand is to allow prices to fall to more affordable levels. Sam Walton made billions with this simple concept.

Despite all the exculpatory evidence, deflation remains economic enemy number one. This is because inflation (the opposite of deflation), is every politician's best friend. More about this later.

CHAPTER

6

PUT IT IN THE VAULT



As the islander's fish-savings increased, storage became an issue. People traditionally kept fish in their huts, but that proved too inefficient and even dangerous. Fish filchers became a big problem.

And while the islanders would have liked to use their excess savings to grow through loans and investments, most individual savers had neither the time nor the training to judge the merits of business propositions offered to them.





Sensing a solid business opportunity, an islander named Max Goodbank decided to launch a revolutionary service.

After guarding his own fish for years, Max knew there had to be a better way to store his savings. And after seeing so many of his neighbors get hoodwinked by slick fish borrowers, he also knew that most people needed help in deciding how their savings should be lent. With these thoughts in mind, he built a large, climate-controlled facility staffed by the toughest galoots on the island. The new "bank" would safely store the island's collective fish savings and consequently solve the theft problem. But this was just the beginning....

Being a true entrepreneur, Max knew that if all he did was charge a storage fee, his profit potential would be limited.



He understood the value of savings and he knew he could do a better job at lending than a typical islander. As a top-notch mathematician, Max was particularly good at evaluating business plans and structuring equitable loans.

With the fish earned from the loans of his neighbor's fish, he would pay interest to depositors and wages to his galoots. He would keep the leftover profit for himself.

The Goodbank Savings and Loan was born!



Just like Able and Duffy, Max initially sought to benefit his own pocketbook. But to do so, he helped solve the island's thorny issues of savings, credit, and theft.

Now, when the "Ables" of the island underconsume, they delegate their investment responsibility to Goodbank by depositing their fish savings in his bank.

Those requiring loans in order to finance capital projects, need only see Mr. Goodbank rather than anyone who seemed to be sitting on a tidy pile of fish.

For the scheme to work, Max had to keep a number of balls in the air at once. First, he had to keep his loan business profitable, which meant he had to carefully screen borrowers, scrupulously collect interest, and foreclose on collateral when loans failed. Second, he had to keep his depositors happy through regular interest payments. Last, he had to attract more borrowers to keep the cycle running. If he failed, he would be out of a job, and his investment would be wasted.

Naturally, with his ability to specialize in the tasks associated with efficient and profitable lending, Max became the island's foremost expert on fish economics. And whereas less specialized lenders tended to be influenced by factors such as personal history, family relationship, and emotion, with Goodbank, it all boiled down to dollars and cents, or rather fins and scales.



Interest Rates

With his personal well-being so intertwined with the success of the bank, Max was in the ideal position to determine the best interest rates to pay depositors and to charge borrowers.

On the lending side, he offered the lowest interest rate to the most secure borrowers (those with the highest ability to repay the loans). For dicier borrowers he charged a higher rate to compensate for the added risk.





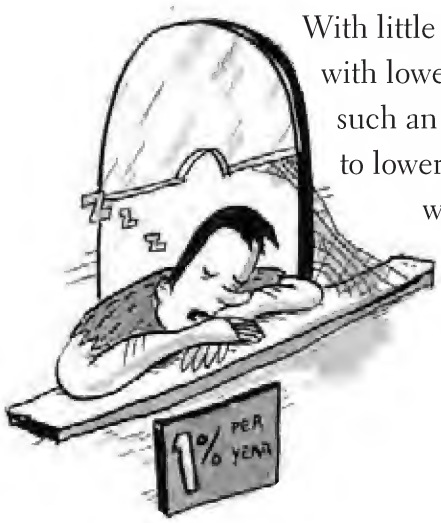


These loan rates then determined how much interest the bank could pay depositors, who received payments on a similarly sliding scale. Longer-held deposits lowered the bank's risk of a fish shortage. Accordingly, higher interest payments were offered to those willing to leave their fish on deposit for a while. People who could not commit to a longer time frame got lower rates.

Although Goodbank administered the rates, the entire interest rate system itself fluctuated according to market conditions that were largely beyond Goodbank's control.

Sometimes big gains in productivity made the island's savings swell. When the vault was filled to the rafters with fish, the bank would be willing to drop the rates charged on loans. That was because the losses would be easier to bear in relative terms, and the healthy economy that produced the savings in the first place would provide a fertile environment for new businesses.





With little need to attract new savings, and with lower rates charged to borrowers, such an environment would also lead to lower payments to depositors, which would discourage savings.

When savings dipped (which is dangerous for an economy), opposite forces would come into play that would tend to encourage savings, thereby replenishing bank coffers.

When the fish were few, Goodbank had to be extra careful with loans. With thin reserves, loan defaults could be critical. In order to compensate for the increased relative risk, Max charged higher rates to borrowers, and offered higher rates to depositors in order to encourage more savings.





Higher interest rates would discourage borrowing and slow business growth. But the higher rates would also encourage savings. Eventually coffers would build up again and rates would then start to drop.

In addition, a lower savings rate indicated a preference for more immediate consumption. As a result, long-term capital investments designed to provide goods for future consumption would be discouraged.

This cyclical interest rate mechanism—firmly regulated by the desire to maximize the returns on the bank's deposits, the fear of losing capital on risky ventures, and individual time preferences for consumption—produced a rate of interest that would stabilize the market.

Most importantly, the safety and convenience of the bank encouraged people to save. Deferring consumption to a later date provided financing for capital projects that would increase future production and raise living standards.

Under Mr. Goodbank's wise and conservative care, the island's savings and commerce continue to grow.

High-Risk Investment

Given his need to continually pay interest to his depositors, Mr. Goodbank tended to shy away from loans that had a high probability of default. He refused to risk the islanders' savings on vacation loans, consumption loans, or any other "fish in the dish" ideas that promised the moon but could offer no realistic assumptions about potential success.

But some savers wanted to take greater risks for greater rewards. Occasionally potential breakthrough projects came along that were very enticing, but ultimately just too risky for the bank to fund.

Sling-Flight Airways pitched an idea that could revolutionize interisland travel.



But Goodbank, true to form, didn't bite.

But that didn't mean that the backers of Sling-Flight were out of options.



A new investment pool had arrived on the scene, run by the flamboyant fish tycoon Manny Fund. Manny took in fish from savers who were not content with the modest returns paid by Goodbank. With these fish he rolled the dice on high-profile projects.

Some of the projects he funded worked out, like the Paradise Beverage Company.



And others did not, like the Blubmarine Underwater Tour Company.



So, while Goodbank continued to finance capital growth through conservative forms of investment, Manny Fund became the choice for the risk takers.



TAKEAWAY

In addition to distorting the credit market by passing laws that favor certain types of loans and certain types of borrowers, government also influences the flow of credit in a more fundamental manner: through its control of interest rates. For almost 100 years, the Federal Reserve (in theory a private bank, but in practice an extension of the Treasury Department), has set the base level for interest rates upon which the entire rate structure rests.

By setting its "federal funds" rate higher or lower, the Fed (as the bank is known) does not dictate the particular rate any bank offers for every loan, but it does move the entire market up or down. Banks will always charge a higher rate to the public than they pay the Fed to borrow money. So when the Fed raises or lowers its rates, businesses and individuals will pay more, or less, to borrow.

The Fed was given this authority in order to keep the economy running smoothly in good times and bad. The theory goes that the collective wisdom of Fed economists could help keep the economy on track by determining the optimal interest rate for any particular moment in time.

For instance, the Fed could boost a struggling economy by lowering interest rates to the point where businesses and consumers would be more inclined to borrow. In very good times, when overconfidence often leads to foolishness, the Fed is supposed to do the opposite and raise rates so that people will think twice about taking out loans.

This system has two massive flaws.

First, it assumes that a small group of people at the Fed can make better decisions than millions of people making independent decisions (also known as "the marketplace") about the proper level of interest rates. But, the Fed has "no skin in the game," as the saying goes. It does not generate the savings and will not suffer if loans go bad. The people saved the money and the bank's profits depend on its wise stewardship. Without this connection, lending is inherently inefficient.

Second, the Fed's decisions are always determined by political, rather than economic, considerations. As low rates tend to make the economy appear better on the surface, push down the cost of servicing mortgages and other loans, and help financial firms make money, there are a great many people who want lower rates. Presidents seeking reelection will always bang the drum for lower rates, and they will pressure the Fed to help out. On their part, Fed policy makers naturally want to be seen as the good guys who help the economy, not the tight-fisted Scrooges who push it into recession.

The members of society who would favor high rates, most notably the savers, have no well-organized interest group. Their voices are never heard. As a result, there is a consistent bias toward holding rates too low, rather than too high. Remember, low rates encourage borrowing and discourage saving. Not surprisingly, the United States has been transformed from a nation of savers to a nation of borrowers.